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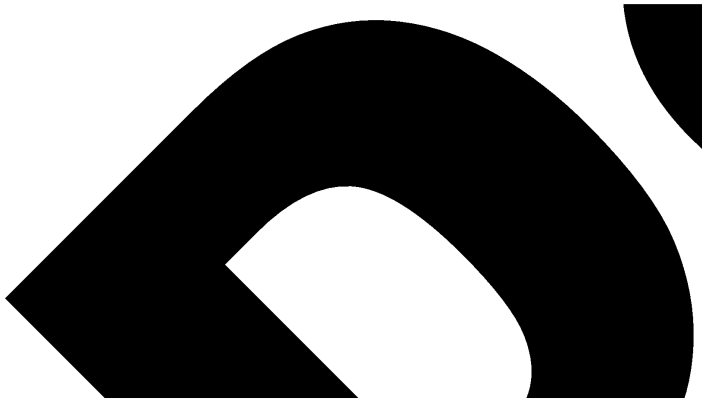

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Secret

DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

International Finance Series, No. 8

New Pressure on the French Franc

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
14 November 1968

INTELLIGENCE MEMORANDUM

International Finance Series No. 8

New Pressure on the French Franc

Summary

The monetary measures announced by French Finance Minister Ortoli on 12 November -- raising the discount rate to 6 percent, increasing the reserve requirements of commercial banks, and placing ceilings on credit expansion -- are designed to reduce the drain on foreign exchange reserves through tighter credit controls. The immediate reaction to these measures, both in France and abroad, has been negative. Since the May-June domestic crisis, capital flight has been continuous and has accelerated in the past two weeks as French speculators exchanged their francs for Deutsche marks.

Between 1 May and 31 October, French official reserves fell by more than $2.6 billion, of which $1.1 billion was accounted for by gold sales. France still has about $4.2 billion in gold and foreign exchange reserves, but increasing losses heighten concern over the stability of the franc. General de Gaulle continues his adamant opposition to devaluation, and he may approve sterner measures, including controls over wages, prices, and foreign exchange transactions, in defense of the franc.

With increasing pressures on France to devalue the franc, and on West Germany to revalue upward the Deutsche mark, the two governments are engaged in a test of wills, with each hoping the other will take the necessary corrective move first.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research.

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1. The makers of French economic policy now find themselves facing a classic dilemma. Committed to expansionary policies aimed at rapid expansion following the setback dealt by the May-June crisis, French officials have seen these policies interpreted both at home and abroad as inevitably bringing serious trouble for the French balance of payments. As a result, capital flight has become chronic, leading to large and persistent losses of official gold and foreign exchange reserves. This condition could be arrested by the application of strongly deflationary monetary and fiscal policies. But such measures in turn would slow or stop the recovery of the domestic economy with inevitable unemployment and consequent labor unrest.

2. French authorities still are searching for the right "mix" of fiscal and monetary policies that will end the drain on reserves and, while restoring the balance of payments, also permit acceptable rates of economic growth. The latest turn of policy occurred on 12 November, when Finance Minister Ortoli announced new monetary measures to restrict the flow of capital from the country. These measures introduce a moderate "tightening" in the monetary system, but include important exceptions to prevent any serious setbacks to domestic economic recovery. The Bank of France discount rate (loan rate to commercial banks) was raised from 5 to 6 percent, while minimum reserve requirements for commercial banks also were hiked. These measures were designed to restrict the availability of credit and at the same time make it more costly. Ceilings on bank lending also were imposed. The new measures, however, left a number of loopholes through which high rates of domestic investment and export financing may continue. The primary aim of the new policy is to clamp down on speculation, particularly in the Deutsche mark, which directly affects the stability of the franc and France's balance of payments.

3. The initial reaction to these measures in France and abroad was negative. Doubting that the government has yet found a way to "brake"

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and "accelerate" the closely linked external and internal sectors of the economy simultaneously, speculators and those with short-term capital to take out of the country sent the franc's dollar exchange rate plummeting to its floor almost immediately when markets opened on 13 November. The Bank of France and the Federal Reserve Bank of New York have been compelled to use French reserves to purchase large amounts of francs to keep the rate from breaking through the floor. A continuation of these operations is expected to be required at least for the rest of this week.

4. Thus both capital flight and reserve losses are continuing at a high rate. Between 1 May and 31 October, French official reserves fell by a total of $2,651 million. Of this, $1,099 million represented gold sales -- including $490 million in gold sold back to the United States, $30 million of it in October. Another $663 million consisted of foreign exchange losses, and $889 million of French assets under the IMF's General Arrangements to Borrow were transferred to other countries. The French noted both during and shortly after the May-June crisis that they would reluctantly accept some reserve losses in favor of promoting domestic recovery and expansion. French officials, however, cannot have expected these losses to continue at the high levels recorded throughout the summer and fall. Serious doubts are now being raised in the principal money markets of the world about the ultimate stability of the franc.

5. The immediate cause for the announcement of the recent new monetary policy measures was renewed pressure on the franc in early November. This arose from a variety of causes: the persistent capital flight, growing fears of domestic inflation (consumer prices rose 0.7 percent in September), and, most important, new and stronger rumors that the West German mark may be revalued upward. West Germany has been flooded with foreign currencies brought in to purchase Deutsche marks in anticipation of a revaluation, and most of the foreign exchange outflow experienced by France in recent days has gone to West Germany for speculation in the Deutsche mark.

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6. President de Gaulle remains adamant against devaluation of the franc, which he archly declares to be "absurd." He admits that tougher measures will have to be taken in the face of rising domestic prices and new external pressures against the franc. This response by de Gaulle suggests that he may approve, in defense of the franc, more stringent controls on prices, wages, and foreign exchange transactions.

7. The external financial problems of France and West Germany have raised a controversy between the two nations. With increasing pressures on France to devalue the franc and on West Germany to revalue the mark upward, the two governments are engaged in a test of wills with each hoping the other will make the necessary corrective move. A West German revaluation would take much if not all of the pressure off the franc. A French devaluation would give the Germans a strong argument against further widening the exchange rate between the two currencies. French and German officials are reportedly to meet soon in an attempt to resolve the issue.

8. France still has about $4.2 billion in gold and foreign exchange reserves. If losses continue to be heavy in coming weeks, however, the crucial point of decision on devaluation may be reached.

9. The devaluation of the French franc would not necessarily bring with it international monetary stability. On the other hand, an upward revision in the value of the Deutsche mark would not only substantially reduce the immediate pressure on the franc, but would improve the international competitive position of West Germany's Common Market associates, the United Kingdom, and the United States.

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